




County of Los Angeles  
**CHIEF ADMINISTRATIVE OFFICE**

713 KENNETH HAHN HALL OF ADMINISTRATION • LOS ANGELES, CALIFORNIA 90012  
(213) 974-1101  
<http://cao.co.la.ca.us>

DAVID E. JANSSEN  
Chief Administrative Officer

February 18, 2004

To: Supervisor Don Knabe, Chairman  
Supervisor Gloria Molina  
Supervisor Yvonne Brathwaite Burke  
Supervisor Zev Yaroslavsky  
Supervisor Michael D. Antonovich

From: David E. Janssen   
Chief Administrative Officer

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**SACRAMENTO UPDATE ON LEGISLATIVE ANALYST'S OFFICE (LAO) ANALYSIS  
OF THE GOVERNOR'S FY 2004-05 BUDGET**

On January 9, 2004, newly elected Governor Arnold Schwarzenegger released his FY 2004-05 Budget proposal to close an enormous and growing State budget gap. Today, the LAO released its detailed analysis of the Governor's proposal calling it "a solid starting point for budgetary negotiations." However, the LAO hastened to add that "a considerable amount of work remains to be done to bring FY 2004-05 into balance and to fully resolve the State's chronic budget-related problems...(and) that *even if* all of its elements were adopted, FY 2004-05 would end with a General Fund deficit of \$0.8 billion." Also of concern, the estimated structural deficit – the recurring gap between revenues and expenditures – would be approximately \$7 billion in FY 2005-06 and \$5 billion in future years. Of special interest to the County, the LAO recommends that the Legislature reject the Governor's \$1.3 billion shift of local property taxes to schools and suggests an alternative way to achieve the same savings.

**THE ECONOMIC/REVENUE OUTLOOK**

The LAO and the Governor are in basic agreement on their assumptions about the economy and revenue growth. Both anticipate that the recent improvement in the economy will continue through 2005 with corresponding revenue growth in the 5 to 6 percent range, providing almost \$2 billion beyond what was forecast in the FY 2003-04 budget. However, the LAO projects somewhat lower personal income tax revenues in the current and budget year, which they project will be \$1 billion less than assumed in the Budget.

## **TOTAL STATE SPENDING**

While the Governor's Budget shows total State spending declining slightly (0.2 percent) from the current year to \$97.2 billion, when adjusted for the use of the economic recovery bond, total spending in the budget year would be \$100.2 billion, a 6.1 percent increase. Similarly, General Fund expenditures would increase to \$82 billion or 5.4 percent. Much of the increase is a result of the expiration of one-time savings and revenues used in FY 2003-04. Worthy of note, according to the LAO, the estimated deficit for the FY 2002-03 budget has improved by \$2.1 billion which has allowed the Administration to use fewer bond proceeds to pay off prior year deficits and to start the budget year with a \$679 million reserve. As a result, the State has more bond proceeds "left over" to address the budget shortfall in future years.

## **THE BUDGET SOLUTION**

According to the LAO, the Governor's Budget proposes to close an \$18 billion budget gap through a combination of solutions of which 40 percent reflect program reductions/savings and 60 percent result from the use of the economic recovery bond, other loans and borrowing, a major cost shift to local governments, and a variety of other means. Of the \$14.4 billion of the solutions in the FY 2004-05 Budget, the LAO estimates that \$5.3 billion, or 37 percent, are one-time only.

The economic recovery bond, which must be approved by the voters in March, accounts for \$5 billion of the budget solutions, including about \$3.7 billion from the bond and \$1.3 billion from lower debt service costs. Of the \$15 billion maximum in borrowing that the bond would authorize, the Budget uses only \$8.6 billion to cover prior year deficits (reflecting the \$2.1 billion improvement noted above) and \$3.7 billion for the current and budget year. As a result, there could be as much as \$2.7 billion available for other budget solutions. The LAO notes that if the recovery bond is not approved by the voters and the State has to rely upon the deficit bond approved in last year's budget, the allowable amount of that bond is now only \$8.6 billion – the new prior year deficit amount. As a result, the Legislature would have to find an additional \$5.0 billion in alternative budget solutions to replace the budget savings that the LAO attributes to the economic recovery bond.

## **THE LAO'S FINDINGS**

In assessing how well the Budget addresses the State's budget problem, the LAO assumes that proposed reductions could not be implemented before April 1 at the earliest. As a result, the LAO concludes that:

- the Budget is modestly out of balance by less than \$1 billion instead of having a \$600 million reserve due to the LAO's lower revenue estimate and higher expenditure estimates;
- there are serious threats to the Budget that could increase the shortfall to about \$4 billion, especially a legal challenge to the use of pension obligation bonds, some major lawsuits, and tribal gaming revenues to be negotiated;
- a \$7 billion operating shortfall is likely for FY 2005-06, largely a result of the expiration of over \$5 billion in one-time savings, and the ongoing structural deficit will remain around \$5 billion through FY 2008-09; and
- the Administration's reform proposals, which are counted on to bring down future year spending, have yet to be developed.

### **CONSIDERATIONS FOR THE LEGISLATURE**

The LAO raises a number of observations and questions for the Legislature to consider. The first is that the budget does not entirely solve the problem for FY 2004-05, even if it were adopted as proposed, and more so if the Legislature rejects some of the Governor's solutions. More solutions will be needed. The second is whether the Budget pushes too much off into the future by not addressing the structural gap more completely. The third is whether, given the first two points, as well as the severity of the reductions in the Proposed Budget, additional revenues should be considered. The fourth is a warning to the Administration that if significant savings are to be achieved from their reforms, they need to translate them into concrete proposals for timely consideration by the Legislature. And finally, the Legislature is advised to address the budget shortfall through timely and decisive action to maximize the potential savings from whatever budget solutions they adopt.

The LAO has provided comments and recommendations on the Governor's specific recommendations in their detailed analysis of the Governor's Budget. Their recommendations on items of interest to the County are discussed below. In addition, the LAO has provided about 12 pages of additional options for addressing the budget problem that County departments will be asked to review and comment on as soon as possible.

## **SPECIFIC RECOMMENDATIONS**

### **The Property Tax Shift**

**For “policy and practical” reasons the LAO recommends strongly and eloquently against another shift of local property taxes to schools.** Such “a sudden and major loss of general purpose revenues ... is not ... a budget ‘solution’ in any real sense; it is simply a transfer of fiscal problems from one level of government to another.” Interestingly, the LAO makes special mention of the fact that counties would contribute over three-quarters of the amount shifted from non-redevelopment agencies whereas in the two previous shifts they were less than half of that total.

Instead, the LAO offers an alternative to save \$1.3 billion that by its own admission “represents an undesirable intrusion into local finance” which they believe “would have fewer negative effects on local governments and their residents than the Administration’s proposal.” The four elements of the alternative include:

- the elimination of three restricted purpose subventions: Citizens Option for Public Safety (COPS) (\$100 million), Juvenile Justice Challenge Grants (\$100 million) and the Public Library Foundation (\$16 million);
- a \$400 million property tax shift from both enterprise and nonenterprise special districts with the allocation by district determined in each county by the Board of Supervisors;
- a \$320 million property tax shift from redevelopment agencies based on a sliding scale that reflects their amount of land under development, as well as whether they met affordable housing obligations and health and safety requirements; and
- a \$200 million reduction to both cities and counties to be accomplished through a .08 reduction in the local sales tax rate (and a corresponding increase in the State rate), with an adjustment to county VLF allocations shifting VLF revenue to cities to limit their loss to \$200 million.

According to the LAO, this alternative “focuses a larger percentage of the property tax losses on those agencies that can offset revenue reductions through user fees or other revenues, if the community so desires.” In the process it would reduce the loss of discretionary or general-purpose revenues to cities and counties and the resulting impact on local services.

## Health

**Children's Medical Services.** The Budget decreases funding for Children's Medical Services Programs (CMS) local assistance funding by \$40.7 million, for a total of \$198.6 million. It would also cap enrollment in the Genetically Handicapped Persons Program (GHPP) and California Children's Services (CCS), establishing a waiting list when enrollment would exceed the proposed caps. **The LAO recommends rejection of the proposed caps because of administrative difficulties and equity issues which outweigh the potential benefits.**

**HIV/AIDS Treatment and Prevention.** The Budget includes \$323.4 million for the Office of AIDS Treatment and Prevention Program, a decrease of \$6.6 million below the 2003 Budget Act. Enrollment in the AIDS Drug Assistance Program would be capped. **The LAO recommends rejection of the proposed cap because the savings could be offset by the future cost of treatment.**

**Medi-Cal Reform.** The Budget calls for a major programmatic restructuring that would require a Federal Waiver. Potential reform strategies could include simplification, a multi-tiered benefit structure for mandatory and optional beneficiaries, co-payments, elimination of some services exceeding standard private health insurance benefit packages, and expansion of managed care to the aged, blind and disabled. The Administration projects \$400 million in savings beginning in FY 2005-06.

The LAO notes that the Governor's proposals are only broad concepts for discussion and **recommends that the Legislature direct the State Department of Health Services to present a more detailed proposal at budget hearings so that it can assess the policy implications and potential savings.**

The LAO further suggests additional opportunities for reform including providing coordinated care to the aged, blind and disabled, simplifying eligibility for families by combining Medi-Cal and Healthy Families coverage, improving the county eligibility determination process, studying the impact of recent Federal Medicare legislation, and advocating for Federal changes to the Medicaid Program that could result in a reduction in State costs.

**Medi-Cal Managed Care.** The Budget assesses a voluntary 6 percent Access Quality Improvement Fee on Medi-Cal managed care plans to leverage additional Federal matching funds and reduce General Fund spending by \$75 million. **The LAO recommends approval of the Governor's proposal and further recommends that the Legislature explore the option of extending such a fee to mental health managed care.**

**Medi-Cal County Administration Costs.** The Budget implements a plan to control county welfare department costs for Medi-Cal eligibility determinations. The control plan would be submitted to county welfare departments by January 2005 and include productivity standards and overall performance standards. Trailer bill language will be proposed to restrict county wage increases to specified cost-of-living adjustments to reduce disparities among counties. **The LAO does not provide any comments or recommendations.**

**Healthy Families Program.** The Budget proposes to cap enrollment at the January 1, 2004 level and implements a two-tiered benefit package, including higher premiums for the more comprehensive package. **The LAO recommends that the Legislature reject this cap because it would create inequitable gaps in coverage and conflict with implementation of policy changes, such as the "CHDP Gateway."**

**Alcohol and Drug Programs.** The Budget includes \$597.8 million, an increase of \$5.1 million above the FY 2003-04 level, for substance abuse prevention programs and \$3.1 million for Drug Medi-Cal treatment services which include perinatal treatment, narcotic treatment, and outpatient drug free therapy.

The LAO notes that the State's substance abuse treatment program for Medi-Cal beneficiaries provides an inconsistent patchwork of services and levels of support for different modes of treatment and treatment populations. **The LAO recommends that the existing community-based system of care be redesigned to provide counties with broad new authority with a new financial structure to decide which modes of treatment will be used and how treatment should be provided. The LAO further recommends that the State assume responsibility for the provision of narcotic treatment services, and provide Buprenorphine, an alternative to methadone, to help contain the rising cost of methadone maintenance treatment.**

### **Mental Health**

**Early Periodic Screening, Diagnosis, and Treatment Program (EPSDT).** The Budget includes \$787 million to provide EPSDT services and proposes various cost control measures. **The LAO concurs with the Administration's proposal.**

**Children's System of Care Program.** The Budget saves \$20 million by eliminating the program, claiming that the 170,000 children served under the Children's System of Care Program will receive medical services through the EPSDT program. **The LAO does not provide any comments or recommendations.**

**Mental Health Managed Care.** The Budget provides a \$10 million increase to reflect increased caseload. **The LAO recommends that the Legislature explore the option**

of imposing a "quality improvement assessment fee" on mental health managed care providers, who would be repaid through increased Federal reimbursements.

**Sexually Violent Predators (SVP).** The Governor's Budget proposes to shift the pre-commitment SVPs to local jails while they await commitment proceedings. **The LAO recommends support for the Administration's proposal to use State hospital beds more cost-effectively by diverting pre-commitment SVPs to county jails. The LAO suggests that the Department of Mental Health be given the authority to ask the courts to transfer from State hospitals to county custody patients who are not guilty by reason of insanity (NGI) and/or incompetent to stand trial (IST).** The State fully funds the SVP patients but not the NGI or IST patients so that this would be a cost shift to counties.

### **Social Services**

**CalWORKs Grants.** The LAO is silent about the Governor's proposal to reduce CalWORKs Grants by 5 percent except to indicate it would result in savings of \$221 million in FY 2003-04 and FY 2004-05.

**CalWORKs Cost-of-Living-Adjustment (COLA).** The LAO is silent about the Governor's proposal to suspend the October 2003 COLA and the July 2004 COLA except to indicate that it would result in savings of \$322 million in FY 2003-04 and FY 2004-05.

**CalWORKs Reforms: Job Search.** With respect to the Governor's proposal to require applicants to search for a job as a condition of eligibility, **the LAO recommends that the Legislature ensure county programmatic and fiscal flexibility by making the policy a county option.**

**60-Day Plan Requirement.** The LAO recommends that the Legislature consider modifying the Governor's proposal to require a completed welfare-to-work plan within 60 days of the receipt of aid to **give counties more flexibility in meeting this requirement.**

**Core Work Activities.** With respect to the Governor's proposal to narrow the list of activities that count toward the first 20 hours of required participation, **the LAO recommends that the Legislature retain as much county flexibility as possible.**

**Non-compliance grant reduction.** The Governor proposes to reduce grants to children by 25 percent, if a sanctioned adult does not come into compliance within one month. **The LAO suggests that the Legislature should weigh the savings from the**

**proposal against the negative impact that the grant reduction may have on families and children.**

**Temporary Assistance for Needy Families (TANF).** The LAO indicates that the Administration's method to achieve General Fund savings by increasing TANF transfers to Title XX is a viable option.

**Food Stamps.** The LAO recommends rejecting the Governor's proposal to repeal recent legislation which expanded eligibility for food stamps, including elimination of the Transitional Food Stamps Program (TFS). The LAO indicates that eliminating these eligibility expansions would result in combined General Fund administrative and California Food Assistance Program (CFAP) savings of only \$3.5 million in the budget year while foregoing \$203 million in Federal food coupons for low-income Californians and a loss of \$4.5 million in General Fund revenue.

**County Block Grant for Immigrants.** The Governor proposes to reduce funding for certain State programs which serve immigrants by 5 percent and consolidate them in a single block grant to counties. **The LAO recommends rejection because the programs are not well-suited for local control.**

**Child Care.** The LAO indicates that the Governor's proposals to significantly reform the State's subsidized child care system lack sufficient detail for the Legislature to weigh budget savings against the loss of child care services for low-income families.

**Foster Care.** The Administration assumes savings in the amount of \$72 million from unspecified foster care reforms. The LAO believes that the savings will be significantly less than budgeted. **The LAO recommends that the Legislature consider reforms to the current specialized care increment rate structure and suggests the development of a detailed plan, including funding sources, to increase the number of available foster family homes through such means as providing subsidized childcare for working foster parents.**

In addition, the LAO recommends increasing the administrative funding for the Foster Care Program and Adoptions Assistance Program by \$150,000 to fund required county evaluations of the State-only children under the new Title IV-E eligibility standards as determined by the *Rosales* decision. The LAO indicates this county re-determination process should save the State \$5.5 million General Fund as more children are shifted to the Federal program.

**Adoptions Assistance Program (AAP).** The LAO indicates that the current AAP provides the maximum foster care grant for virtually every child who is adopted from the foster care program, regardless of whether or not that child would be "hard to place" in



an adoptive home, which has turned AAP into one of the fastest growing social services programs in terms of caseload and cost. **The LAO recommends the enactment of legislation that: 1) sets grant levels at an amount that recognizes the adoptive parents' financial responsibility for their adoptive children; 2) better ties benefit levels to the needs of adoptive children; and 3) narrows the definition of "special needs" to focus the program's financial assistance on those children who are likely to benefit the most from such aid.**

**In-Home Supportive Services.** The LAO recommends that the Legislature assess the impact of the Governor's proposal to eliminate residual (State-only) services but makes no policy recommendation. **However, the LAO believes that the proposal to eliminate payment to relative care givers merits approval because it is a service reduction that can probably be absorbed by the family.** The LAO did not make a recommendation on the proposal to limit State participation in provider wages but indicates that the Legislature should assess the impact of this proposal on recipients, as well as the estimated savings.

**Community Care Licensing (CCL).** With respect to the Governor's proposal to increase the CCL fees over the next three years, **the LAO recommends the enactment of legislation to establish a fund for the CCL fees and make the funds available upon appropriation by the Legislature to increase legislative oversight.**

**County Share of Child Support Collections.** The LAO is not supportive of the Governor's proposal to eliminate the county share of child support collections, indicating it could create a further disincentive for counties to invest in collecting child support payments and instead **recommends allowing counties that meet State and Federal performance measures to keep their share (2.5 percent) of the assistance collections.**

### **Justice and Public Safety**

**TANF.** The Governor's Budget funds the juvenile probation services for only the first three months of FY 2004-05, eliminating all funding as of October 2004, resulting in a loss of \$61.9 million to the County Probation Department in FY 2004-05 and \$83 million in the following year. The LAO analysis indicates that the proposed TANF block grant reduction could result in the loss of core probation services for juvenile offenders, lower the level of public safety, and increase General Fund costs due to a greater number of Youth Authority commitments. **The LAO suggests as an alternative that the Legislature consider eliminating or suspending the Citizens' Option for Public Safety (COPS) and the Juvenile Justice Crime Prevention Act (JJCPA) grants program (if these programs are not eliminated as part of an alternative to the property tax shift).**

**COPS.** The Budget maintains the \$100 million current funding. The LAO indicates that this program lacks a specific measurable statewide objective and that its elimination would likely have a minimal effect on public safety. Elimination would result in a loss to the County of approximately \$7.4 million.

**JJCPA.** The Budget maintains the \$100 million current funding. The LAO notes that in many counties, a significant portion of the JJCPA grants allocated in FY 2004-05 will not be spent until FY 2005-06, giving those counties a year to adjust to the loss. Elimination would result in a loss to the County of approximately \$28 million.

**Booking Fees.** The Governor proposed to eliminate the reimbursement to cities and special districts for booking fees paid to counties, as well as the authority of counties to charge booking fees. **The LAO recommends that the reimbursement be eliminated but opposes the elimination of county authority.**

**CYA Sliding Scale.** The LAO recommends that the sliding scale fee for county commitments to the California Youth Authority be replaced by a flat rate covering the full cost to the State.

**Parole Reforms.** The LAO recommends that the Legislature explore opportunities for additional savings by expanding parole reforms to reduce the prison population which could increase costs to local agencies.

### Transportation

**State Transportation Improvement Program and Prop 42.** The Governor's Budget proposes to reschedule \$2.6 billion in projects into subsequent fiscal years resulting in the loss of \$30.5 million to the County in FY 2004-05. It also suspends transfer of \$1.127 billion, including \$179.5 million to local governments which will result in a loss of \$18 million to the County for repaving streets in unincorporated areas in FY 2004-05. **The LAO recommends that transportation funding be stabilized by: 1) asking voters to repeal Proposition 42; 2) increasing the gas tax to replace Proposition 42 funding; and 3) indexing the gas tax to adjust for inflationary cost increases.**

### Resources and Environmental Protection

**Natural Resources.** The Budget recommends increasing State Park fees to raise \$18 million to offset General Fund reductions, reducing funding for the Department of Fish and Game for stream clearance and restoration activities by \$1.8 million, and increasing funding for implementation of the Marine Invasive Species Act by \$1.2 million. **The LAO supports these actions, but also recommends that the**

**Legislature set parameters for park fees, and that greater use of contract services be explored.**

The Budget defers appropriation of funds from Propositions 40 and 50 while the Administration explores ways to reorganize and streamline resource conservation efforts. The LAO recommends that the Legislature obtain reports from the Administration and consider whether the proposals are consistent with the bond measures and prior legislative direction. **The LAO also recommends legislation to reduce the State's share of funding for federally authorized flood control projects, with estimated savings of \$115 to \$230 million in future years.**

**Environmental Protection.** The Proposed Budget recommends a decrease of \$35 million for the Air Resources Board, largely due to expiration of \$29.6 million in one-time grant funding. The Proposed Budget also reduces Water Resources Control Board appropriations by \$10 million, impacting implementation of statewide septic tank standards, water quality management and planning, and investigation of emerging pollutants, including Chromium 6. The Proposed Budget recommends that the Integrated Waste Management Board use \$52.3 million from the Electronic Waste Recovery and Recycling Account for implementation of the Electronic Waste Recycling Program to reduce the huge stockpile of electronic devices, such as computer monitors and televisions. **The LAO does not comment on these actions, but does recommend that some costs be shifted from the General Fund to fees, such as charging private property owners for State fire protection services, saving \$150 million, and raising developer fees for coastal development permitting, saving \$7.8 million. The LAO also recommends that the "beneficiary pays" principle be applied to the CALFED Bay-Delta Program, by establishing a fee on a broad group of water users who benefit from CALFED activities.**

### **General Government**

**Public Library.** The Governor recommended continuation of the current year funding level. **The LAO, as part of their alternative to the property tax shift, is recommending elimination of the Public Library Foundation which provides approximately \$1.6 million to the County Library.**

### **Land Use**

**Housing Element.** Under current law, every city and county is required to prepare a Housing Element as part of its General Plan which assesses the condition of the housing stock and outlines a five-year plan for housing development. The Governor's Budget proposes to defer reimbursement for the mandated portions of the Element. The LAO indicates that this regional planning mandate costs more than the Legislature

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expected and does not ensure the construction of affordable housing. **The LAO recommends that this mandate be eliminated.**

DEJ:GK  
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c:     Executive Officer, Board of Supervisors  
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